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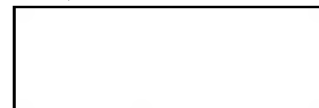
DCI CONGRESSIONAL BRIEFING

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Introduction

In response to your request for a briefing on the economies of the USSR and the PRC, I will begin with the USSR, stressing recent developments concerning Western trade, the energy situation, and agriculture. I will then turn to China and conclude with a discussion of the military situation in these two countries. I will use US-Soviet and US-Chinese comparisons when they seem appropriate and useful.

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THE SOVIET ECONOMY

I. Overall Performance

A. By steadfast attention to industrial development, the USSR has become the world's second largest economic power.

1. It now has a gross national product of \$660 billion, slightly more than half the size of US GNP.

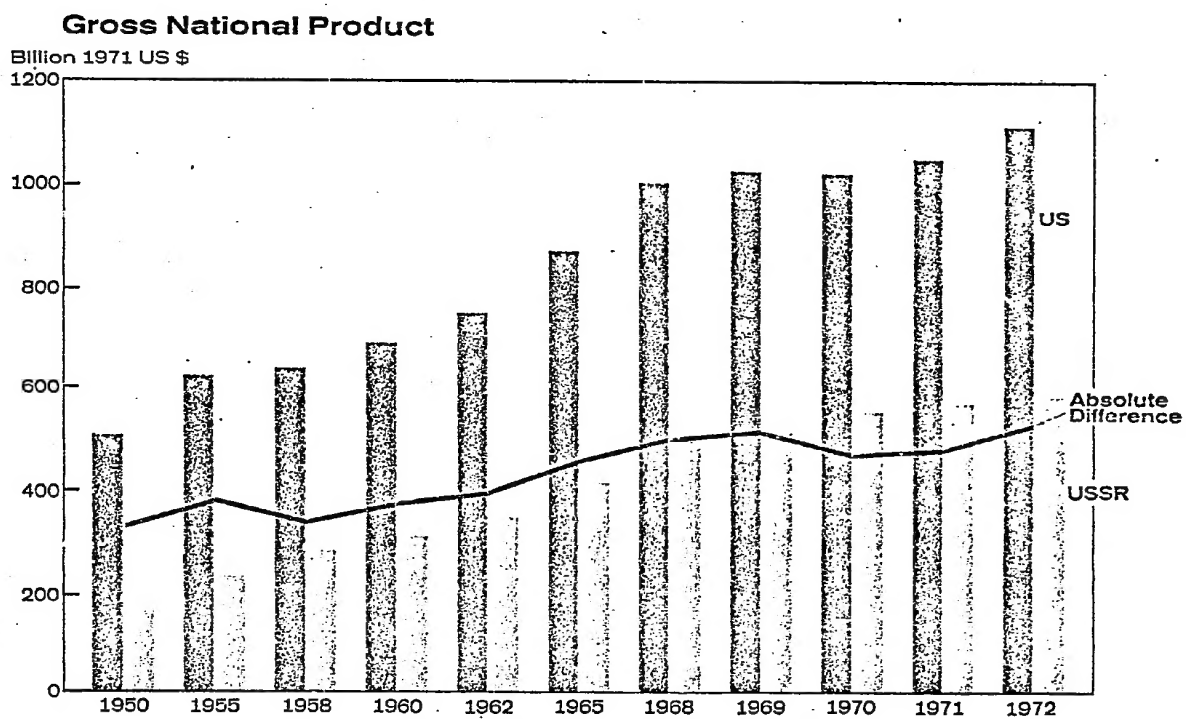
[Figure -- US-USSR GNP, 1950-73]

2. Soviet economic growth was especially rapid in the 1950s as the USSR recovered from wartime devastation. After 1958 the pace gradually slowed. Since 1970, the rate of growth has been lower in the Soviet Union than in the US.
3. In absolute terms, the gap between the US and Soviet economies has increased in recent years.

B. The major support for Soviet economic growth has been the leadership's willingness to devote increasing shares of national output to investment.

1. The share of GNP devoted to investment in new buildings and equipment has grown steadily since the 1950s. The USSR now spends over

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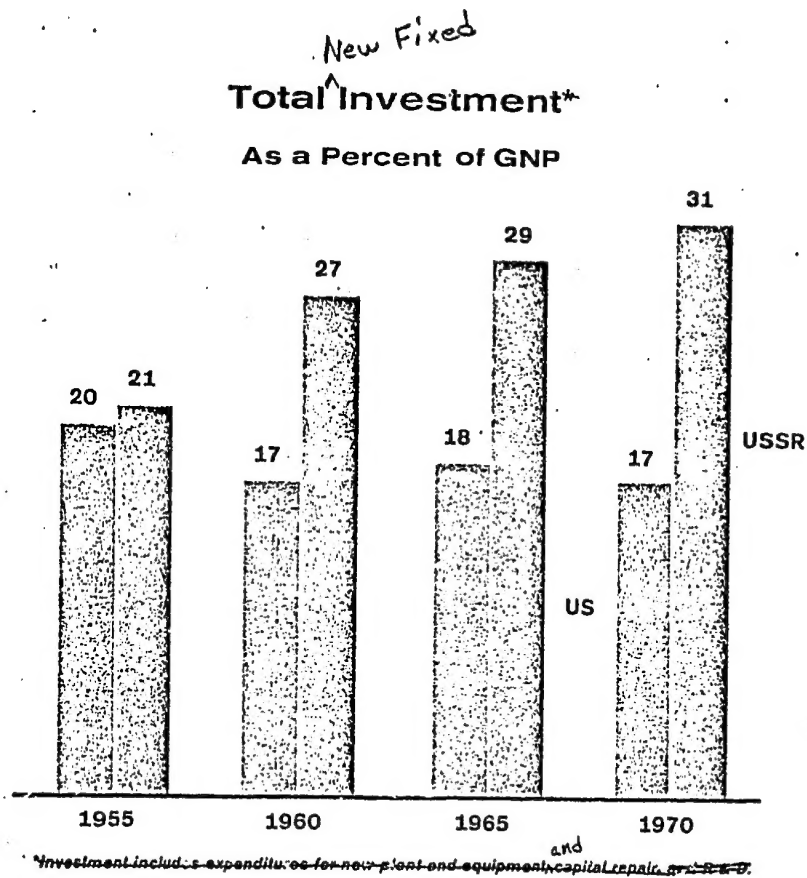


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one-fourth of its national product on new buildings and equipment; the US spends less than one-fifth for this purpose.

/Figure -- Total New Fixed Investment as a Percent of GNP, 1950-73/

2. Soviet defense and space spending has been growing about 3% per year since 1960. The economy has been growing faster, however, and the share of defense spending has declined.
3. Military expenditures impact on the Soviet economy principally by appropriating some of the best materials and highest-quality skilled and professional manpower. But defense requirements are not the principal Soviet economic concern. Although the civilian economy would surely benefit from having more of these scarce, high-quality resources, the transfer of a substantial share of the resources used in military programs to civilian purposes probably would not boost overall economic growth much. The problems bothering the leadership are of a different kind, and I will turn to them later in my presentation.



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4. Because of the policy favoring economic growth, the Soviet population has had to be satisfied with a smaller share of the national product than its US counterpart.

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- a. In 1973 the average Soviet citizen consumed about one-third as much goods and services as a US consumer. But this comparison fails to reflect fully the inferior quality, assortment, and styling of Soviet clothes and durables; the chronic shortages; or the long queues at retail stores.

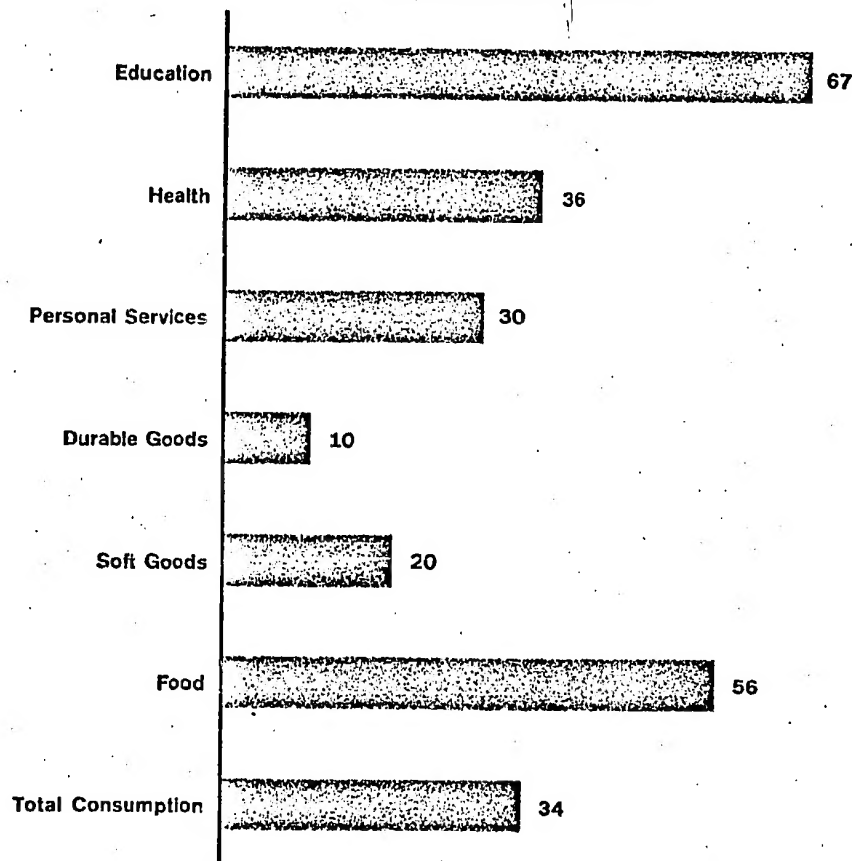
/Figure -- Per Capita Consumption, US-USSR/

- b. Even compared with Eastern Europe, the level of living in the USSR is markedly low.
- c. Except for sewing machines, Soviet consumers enjoy only a fraction of the durables owned by US consumers. Many durables -- automatic washers, dryers, and freezers -- are not manufactured or sold in the USSR.
- d. The situation is gradually improving -- particularly for those on the bottom rung of the economic ladder. In the last two years, production at the new Tol'yatti plant has brought about large increases in passenger car output. This has reduced the waiting period for a new car from 6 years to 2-3 years. Soviet households also can buy furniture and the better quality refrigerators with less of a delay.

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### Per Capita Consumption, 1970

USSR as a Percent of US



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/Figure -- Stock of Consumer Durables, US-USSR/

e. Soviet consumers receive enough to eat in terms of daily calories. But their diet is heavily weighted with starches and low in meat, vegetables, and fruit. Although per capita consumption of meat has increased by one-fourth since 1965, the average Soviet citizen still eats only about 40% as much meat as his US counterpart.

Under Brezhnev, the USSR has made meat consumption the basic plank in its consumer program.

/Figure -- Average Diets, US-USSR/

## II. Performance by Sector

A. Turning now to the Soviet strategy of economic development in which industry has been the showpiece.

1. During most of the postwar period, industrial production grew faster in the USSR than in the United States.

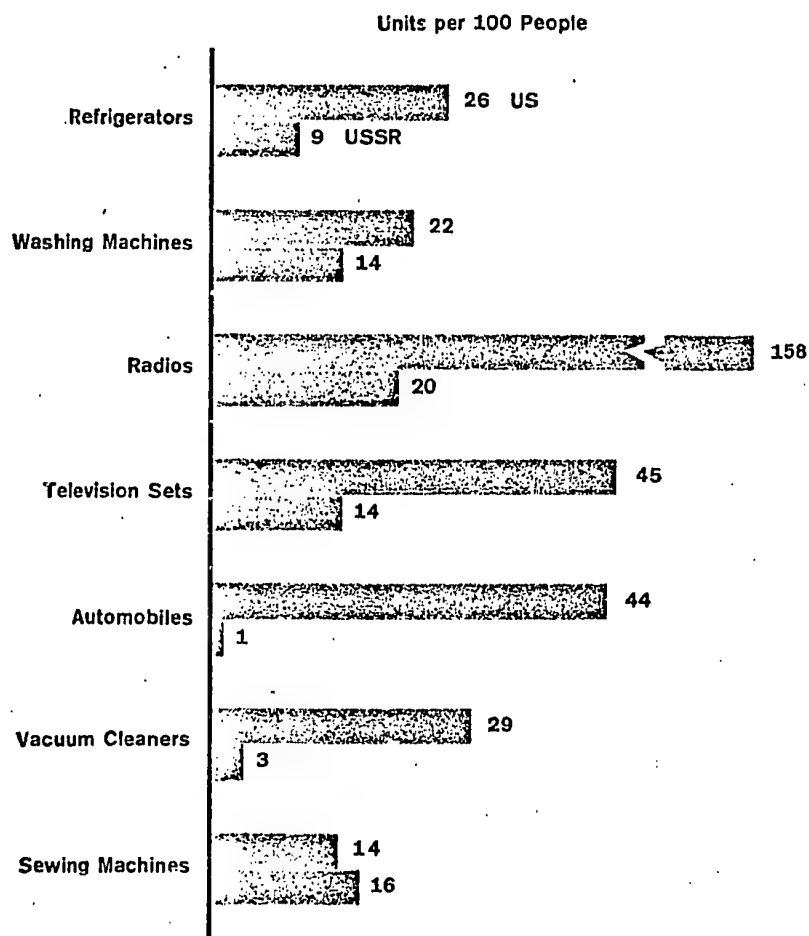
/Figure -- US-USSR Industrial Growth/

2. Industrial development in the USSR has emphasized heavy industry. In its single minded focus on economic growth, producer goods have been favored to the neglect of consumer goods.

/Figure -- Output of Producers' Goods, USSR as a Percent of US/

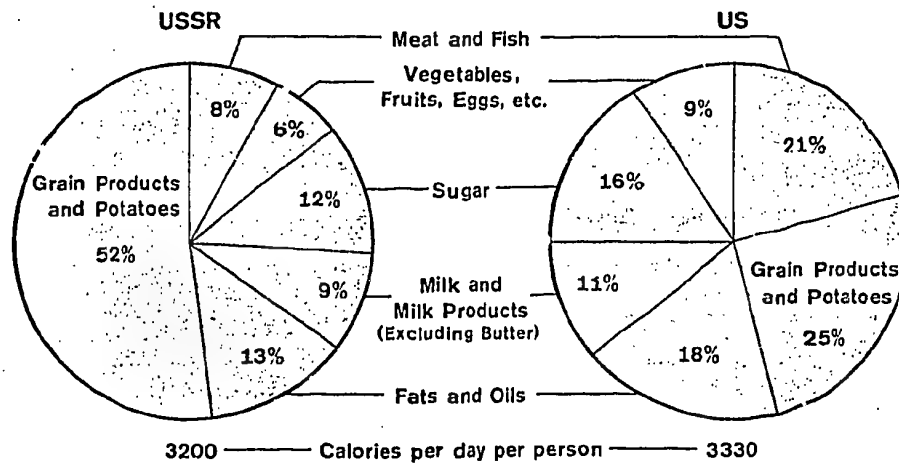
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### Stocks of Consumer Durables, 1970

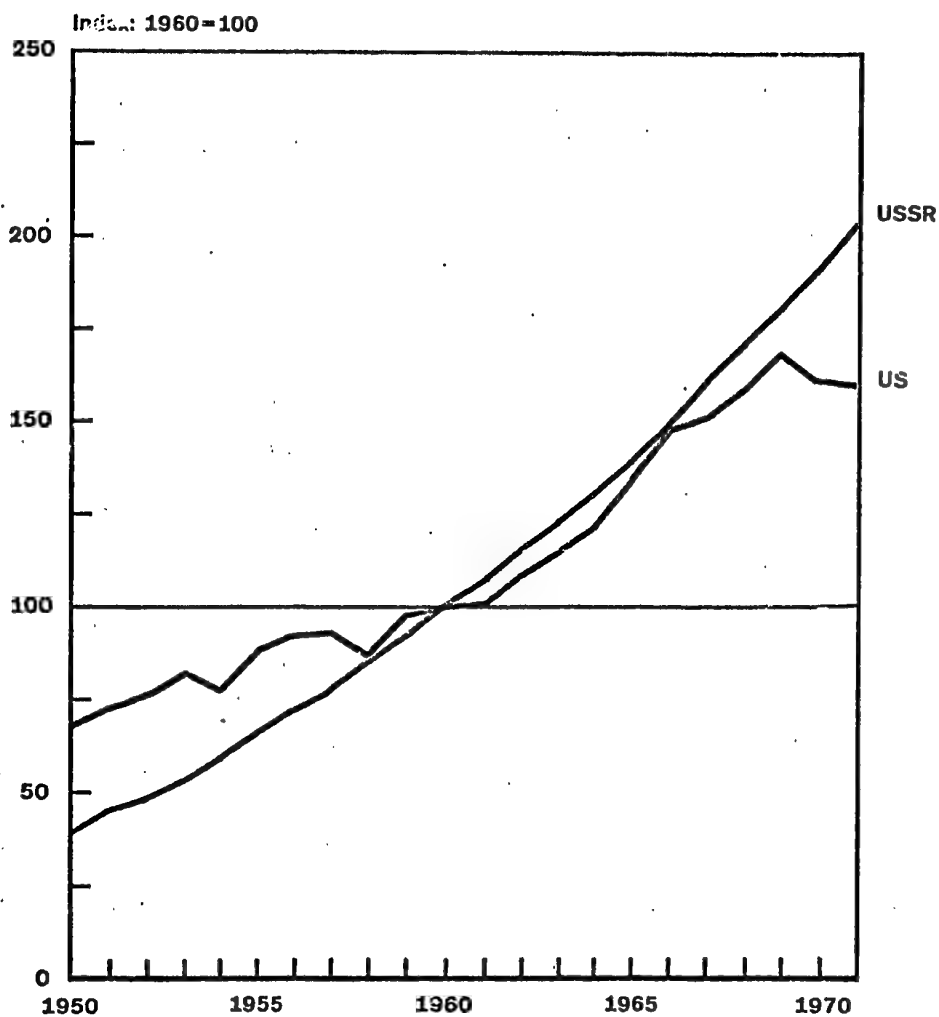


## Average Diets, 1971

Composition of Diets

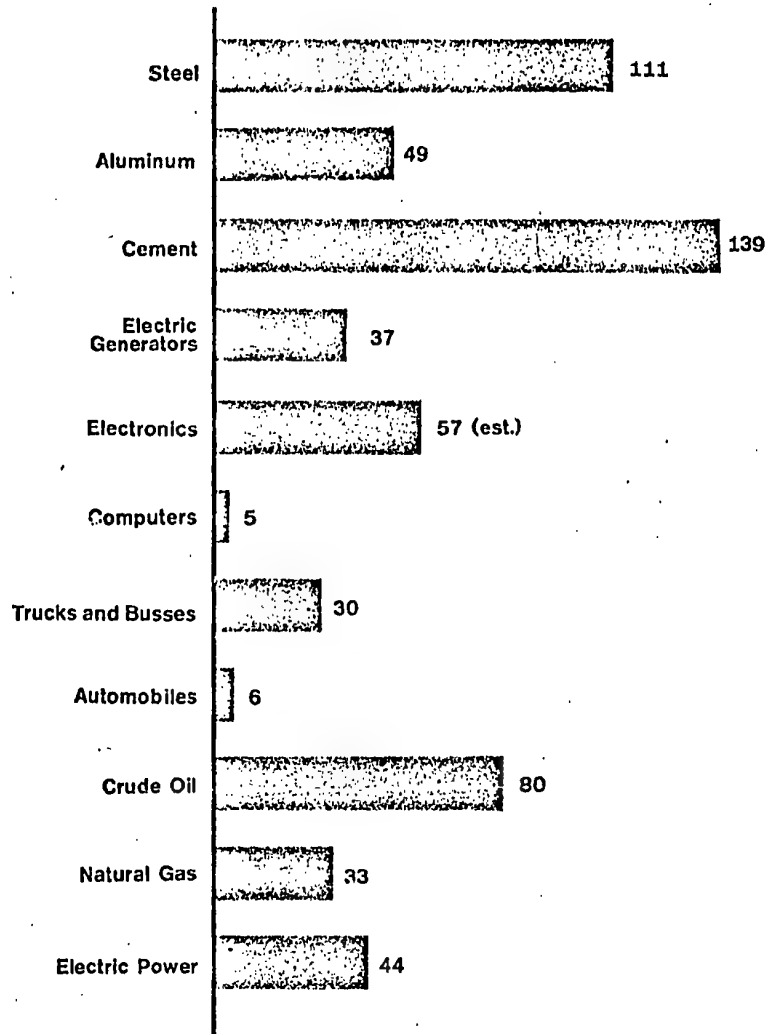


## Industrial Growth



## Output of Producers' Goods, 1971

USSR as a Percent of US



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3. In the past, Soviet industrial production has been deficient in quality and variety. The leadership has been striving to overcome these shortcomings.
4. Soviet industrial managers, however, are hampered first by the relatively low technological levels of their plant and equipment. The planners also criticize their inefficient use of industrial materials, although the managers can blame in turn the shoddy equipment turned out by domestic machinery enterprises and failures in industrial supply.
5. Efforts to upgrade domestic machinery and economize on the use of industrial raw materials during the past two years have had only limited success.

B. Soviet industrial strength has been based above all on abundant raw material and energy sources. These resources are still available but are more expensive now.

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1. The USSR's production of metals and minerals is sufficient in most cases to provide for both domestic requirements and Eastern European needs. The major exceptions are tin and rubber, which have to be imported in large quantities.
2. Nevertheless, the Soviet Union has already exploited many of its most accessible mineral deposits. The bulk of the remaining reserves are located in Siberia or the Far East where the severe climate and lack of transportation and local labor hinder development.

Figure -- Comparison of Output of Metals and Minerals in the US and the USSR

3. As in the US, Soviet economic growth has also depended on the exploitation of huge energy resources.

- a. But there are substantial differences in the pattern of energy consumption in the two countries.

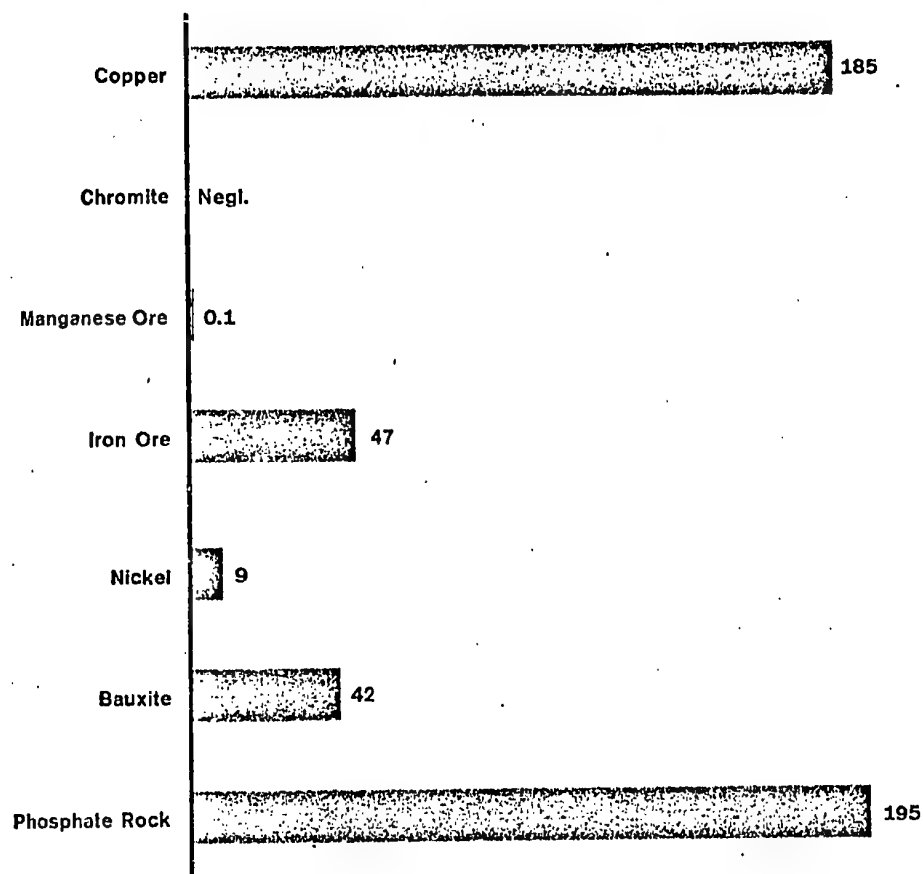
Figure -- US-USSR Primary Energy

- b. The shift toward oil and gas in the Soviet energy balance has been rapid. Petroleum has also been supplied to Eastern Europe and the West in growing quantities.

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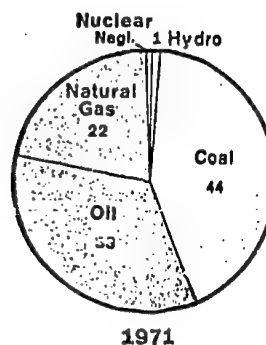
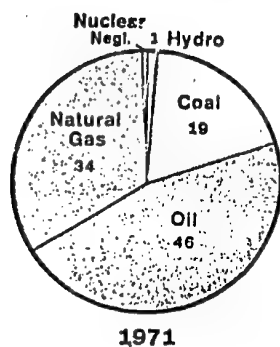
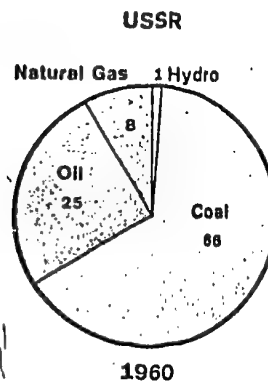
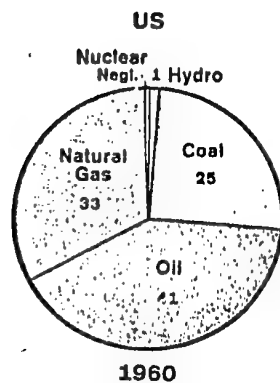
## Output of Metals and Minerals, 1970

US as a Percent of USSR

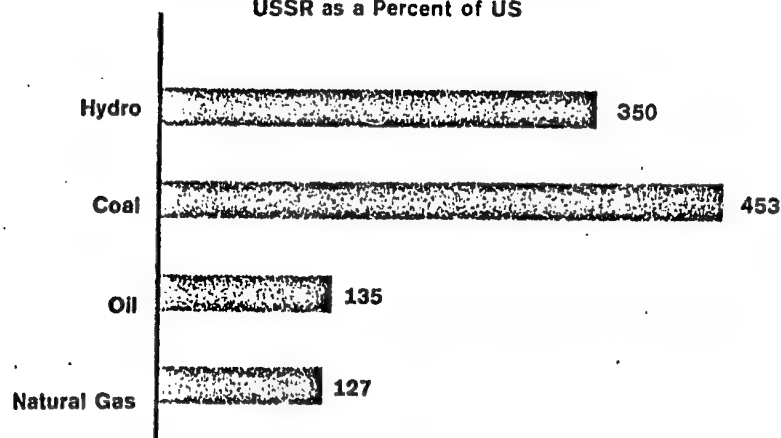


## Primary Energy

### Consumption Percent



### Reserves, 1971 USSR as a Percent of US



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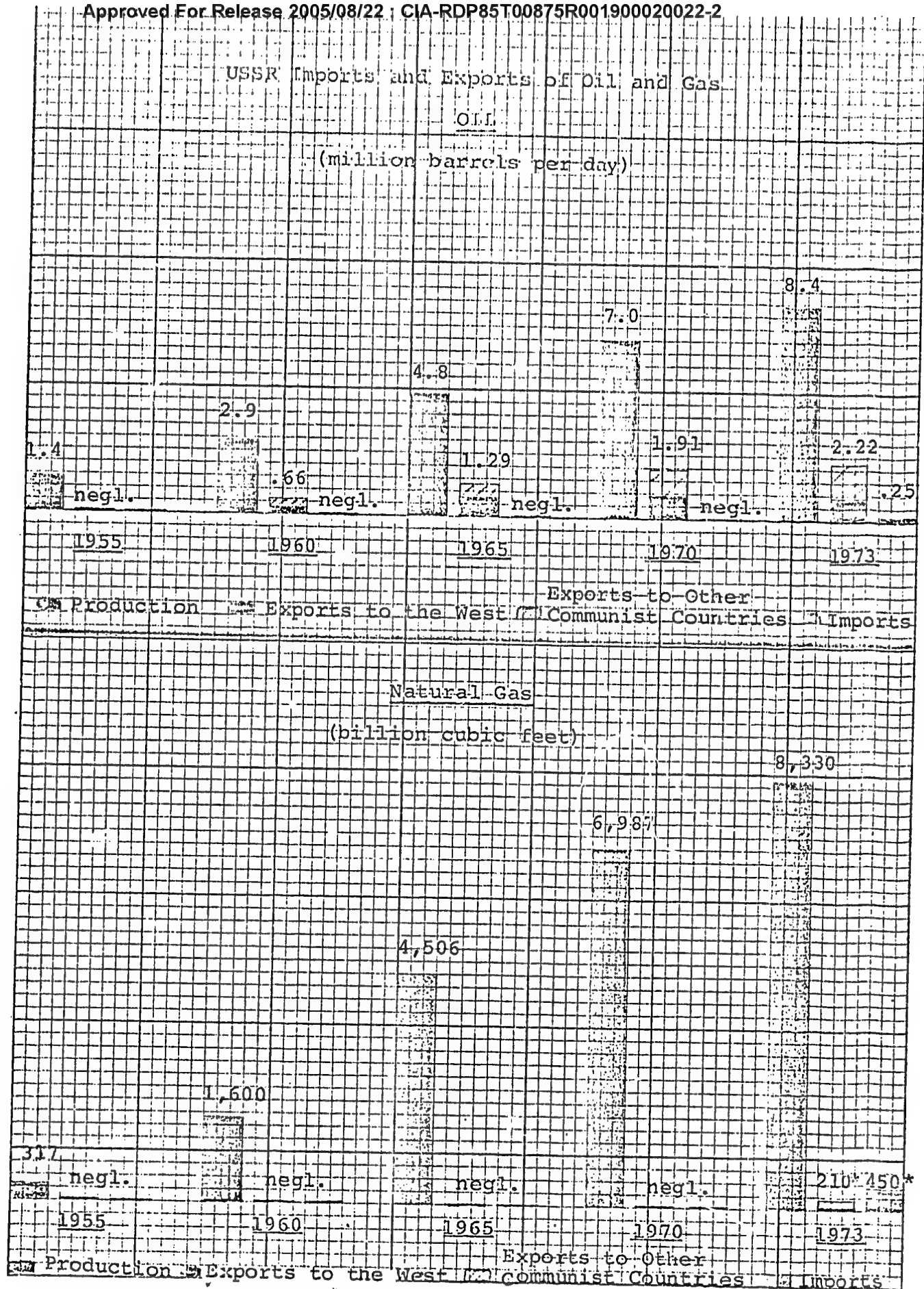
c. In recent months Soviet petroleum officials have complained about the headaches that the world energy crisis has given them.

- (1) They claim that the USSR does not have enough oil to simultaneously meet its own requirements, fill the needs of other socialist countries, and continue to expand deliveries to established markets in capitalist countries.

Figure -- USSR Imports and Exports of Oil and Gas

- (2) Although crude oil output was below plan in 1972 and 1973, the threat of shortages similar to those facing the US is not imminent. The USSR is a net exporter of about 2 million barrels per day of oil, almost one-fourth of total domestic production. About one-half of these exports go the West, especially Western Europe.
- (3) Moscow has little, if any, uncommitted oil, with which to expand sales to the West, even though, its present prices, they earn a great deal of hard currency.

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- d. The expanding demand for oil and gas comes at a time when production from existing fields is leveling off. The development of Siberian and offshore deposits must fill the gap.
  - (1) The exploitation of these new sources will require a huge investment.
  - (2) Moreover, without foreign -- and especially US -- help, development will be delayed because the USSR lacks some of the critical technologies needed to drill at great depths and offshore or to pipe gas across the Siberian permafrost.
- e. The USSR stands to profit from the international oil situation, particularly in the long-run.
  - (1) Soviet hard currency earnings should rise sharply because Moscow will get higher prices for its oil and gas from Western importers, even if the quantity sold remains at, or near the 1973 level.
- f. Soviet ability to exploit the situation in the short-run is limited by its inability to expand production rapidly and by Soviet commitments to supply a major share of

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Eastern Europe's oil supplies through 1975 at fixed prices -- about \$2.50 per barrel -- approximately one-fourth of the current market price.

(1) Nevertheless, Moscow is unlikely to reduce its commitments to Eastern Europe to permit larger sales to the West. The economic disadvantage of such sales is offset by a strong political motive to avoid upsetting the East European economies.

g. Moreover, in the short-run the Soviet Union also has been stung by the higher prices the Arab countries are charging for oil procured from them.

(1) Although the quantities are relatively small (300,000-400,000 bpd), most of this oil is delivered on Soviet account to other Communist countries -- primarily to Eastern Europe, which relies on such deliveries for 15-20% of its total oil imports.

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(2) During 1973 the Soviets obtained oil from Arab countries at relatively low prices under barter aid and trade arrangements. Then, in December Iraq and Libya halted deliveries of crude oil to the USSR because Moscow refused to pay higher prices -- about \$17 a barrel. Iraq also requested that the Soviets pay for oil in hard currency.

(3) Since December 1973, Iraqi crude oil seems not to have been shipped to the USSR. As a result, Soviet plans to obtain 400,000 barrels per day of Iraqi oil during 1974 may not be realized.

C. Let's turn now to a real economic headache. Soviet farms remain the weakest link in the economy despite the massive investments devoted to agriculture under Khrushchev and Brezhnev.

1. Of all sectors of the US and Soviet economies, agriculture offers the greatest contrast in terms of organization and efficiency.

a. Successive Soviet leaders have had recurring difficulties in assuring an adequate food supply for a growing population.

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- b. While the USSR has been expanding sown acreage in an effort to increase production, the United States -- until recently -- had been reducing the area under cultivation and struggling with farm surpluses.
2. Soviet agriculture is handicapped by a short growing season and an extreme continental climate. As a result, production is highly variable. The crop failure of 1972 followed by a record 1973 harvest is only the most recent example of the large swings in the crop yields.
3. Soviet farm production has climbed far above the level of a decade ago. But it is still not large enough to provide the quality diet that the Soviet population desires. As in other developing countries, the demand for meat is rising faster than incomes, placing a severe strain on the Soviet grain-livestock economy.
4. Changes in the size of the Soviet grain crop have world-wide repercussions.
  - a. Since 1965, Brezhnev's program to provide the Soviet people with a better diet has pulled up the demand for grain for use as feed.

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- b. Through 1971, grain production did not keep pace with demand, and deep inroads were made into government stocks.
  - c. In 1972, with stocks at a dangerously low level, bad weather produced a poor grain crop. Rather than abandon the livestock goals, the regime imported massive quantities of grain -- over 24 million tons in fiscal year 1973. Of this total, 18 million tons were wheat, to replace the Russian wheat that had been fed to livestock.
  - d. The United States supplied most of the Soviet grain imports -- 10.5 million tons of wheat, 3.7 million tons of corn and a little rye and barley. These supplies of foreign grain probably would not have been available -- at least not on such a large scale -- if detente had not improved US-Soviet relations.
5. In 1973 the gross Soviet grain harvest was a record -- about 222 million tons. After discounting for unusually high moisture content, we estimate the net usable grain at about 170 million tons.

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- a. The record harvest means that the USSR will have to import considerably less grain in fiscal year 1974 -- perhaps 6 million tons of wheat and 6 million tons of other grains. About 10 million tons will be supplied by the US.
- b. The record crop and continuing imports will not only permit a rebuilding of stocks and continued exports to client states but also will allow the Soviet Union to offer grain for political purposes. The loan of 2 million tons of wheat to India last year demonstrates the flexibility the Soviet regime now enjoys.
- c. The leadership, however, is well aware of the annual variations in grain output. The possibility of another poor grain crop and increased need for grain imports undoubtedly will continue to influence their attitude toward detente for many years to come.

### III. Looking at Soviet Perceptions of Their Economic Situation

We See That:

- A. Soviet leaders view the past economic record with a sense of accomplishment and are not apologetic about their prospects.

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B. Nevertheless, the Politburo -- like other governments in the world -- has some persistent economic issues to deal with.

1. The fact that, despite great progress, the USSR remains far behind the US in a number of key areas troubles Soviet leaders; the emergence of Japan as a major economic force has add to this discontent.
2. The slide in the GNP growth rate of course worries the leadership because catching up with the West depends on vigorous economic growth. Declining rates of growth in productivity are the core of their problem.
  - a. Past growth was based on large increments of productive farm land, new plants and equipment, and workers. Except for labor, growth rates have declined sharply.
  - b. The chart that we are showing now sheds some light on this problem. It shows the rates of growth of manhours worked, fixed capital, and farm land in the Soviet economy. The chart also presents our rough estimate of the extent to which changes in both the quantity and the productivity of manhours, land, and capital were responsible for past growth in GNP.

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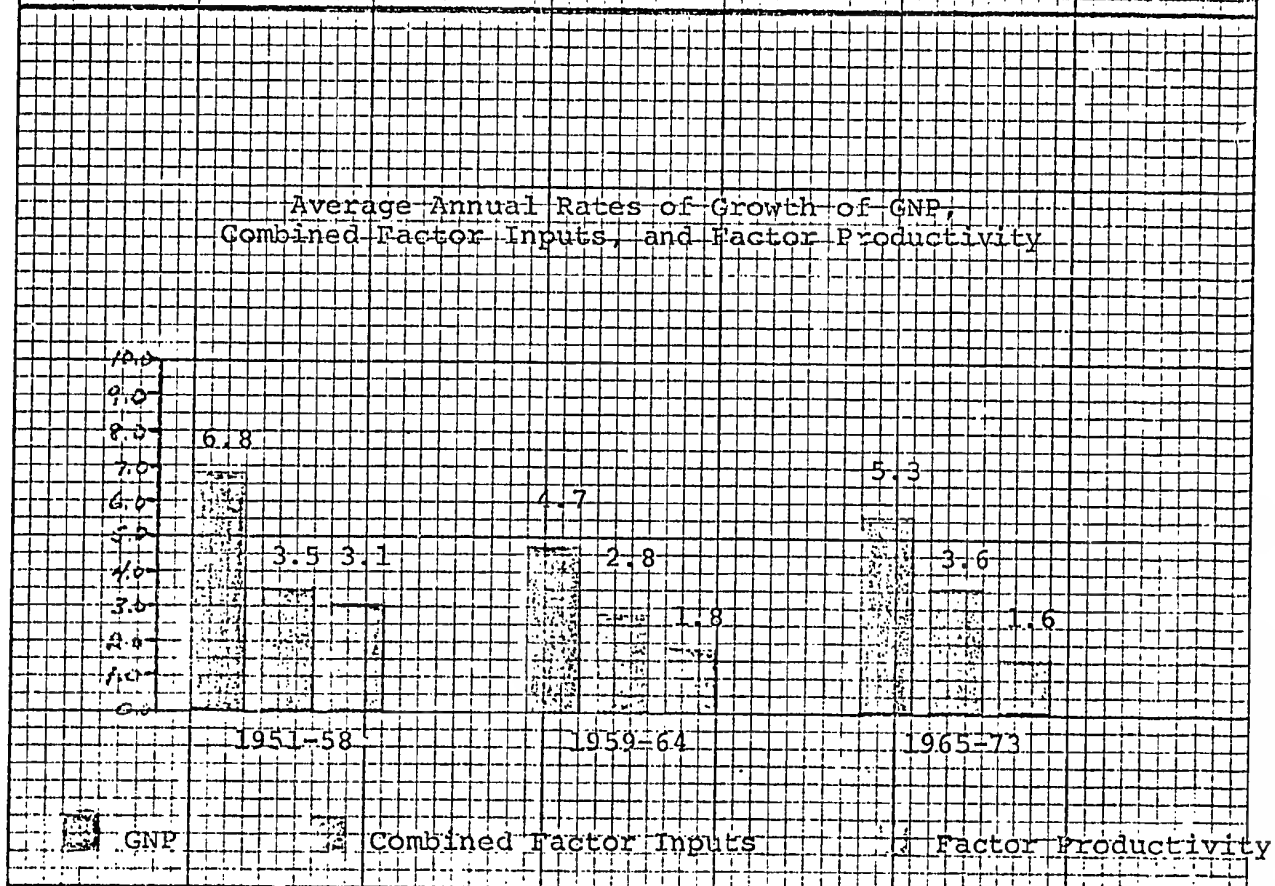
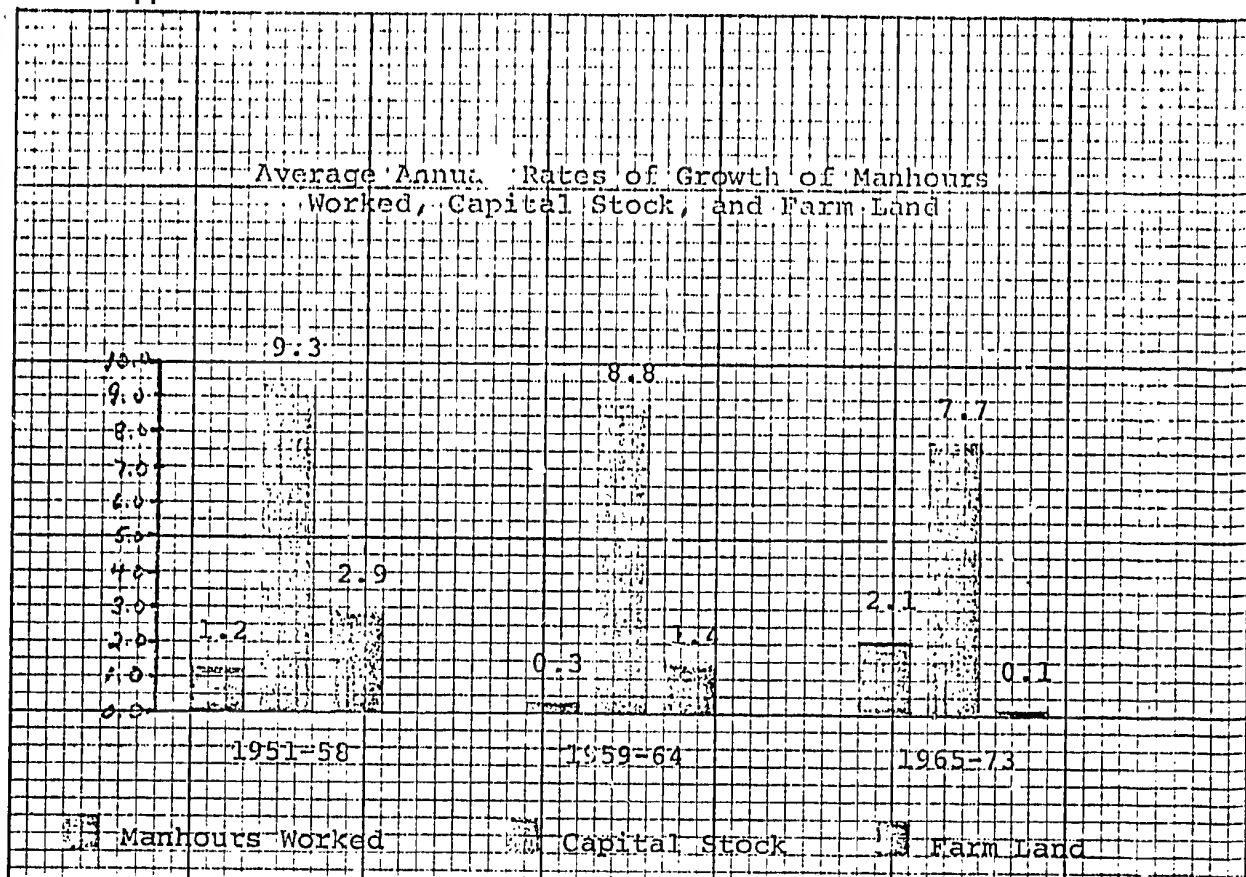
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Figure -- Growth of Manhours, Capital and Factor Productivity in the Soviet Economy, 1950-80

From 1950 to 1958, very rapid growth of capital stock and the farm land added in Khrushchev's virgin land campaign helped push the rate of growth of GNP to almost 7% per year. (The rate of growth of manhours was held down by the delayed effects of the low wartime birth rate.) But -- at the same time -- the productivity of land, labor, and capital increased almost as fast as combined factor inputs did.

- c. Before Khrushchev's fall from power, Soviet growth slowed because the rate of growth of inputs declined and because the productivity of land, labor, and capital fell off. The Brezhnev coalition was able to pull the rate of Soviet economic growth up somewhat in 1965-1973. But Brezhnev's success depended on a faster rate of increase of manhours worked in the economy. The combined productivity of land, labor, and capital continued to fall. Soviet leaders have repeatedly singled out this productivity problem as their chief economic concern. They realize that in the future their economy will have to depend on productivity gains rather than on massive additions of men and equipment.

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3. Another way of looking at the question of productivity is to compare labor productivity in the USSR and the US. In spite of a volume of investment per worker nearly up to US levels in recent years, labor productivity in Soviet industry is roughly half the US level. Soviet industry grew faster than US industry because employment, not productivity increased more. Similarly farm labor is only about 10% as productive in the USSR as in the United States and the gap is not shrinking, even though Soviet agriculture has received much larger investments in the past decade.
4. The consistently poor performance in productivity stems from the many managerial problems of a centralized and bureaucratic socialism. Rewards and pressures are directed toward increasing output, while the introduction of new technology involves risks of failure.

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- a. Until recently, Communist planners believed that intensive domestic R&D plus "borrowing" the latest Western technology would enable the USSR to gain economic superiority. However, they underestimated the pace of Western technology, particularly in Germany and Japan, and overestimated the efficiency of their own R&D effort. As a result, the gap between Communist and Western technologies has gradually widened, leading to increasingly intensive Soviet efforts to acquire Western technology.
- b. Thus, Marxian concepts concerning the inevitability of Western economic collapse and the superiority of communism have quite given way. Instead, Moscow now considers trade with the developed West as essential to close the technological gap.
- c. The major channel that the USSR uses to acquire technology from abroad is the outright purchase of machinery and equipment.

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- (1) Other channels have included the acquisition of technical data, contacts with Western firms and scientists, and formal arrangements for joint research and exchange of scientific and technical information.
  - (2) None of these channels has lived up to Communist expectations. Western equipment frequently is not as productive in a Communist setting as it is on native ground. Attempts to exploit foreign technical data or copy foreign machinery have had mixed success. In some military fields, the results of reverse engineering have been good; in civilian sectors, the outcome has been less happy.
- d. The onset of detente has dismantled some of the traditional obstacles to Soviet acquisition of US technology. Medium-term and long-term credits were extended by the United States after May 1972, resulting in a large increase in Soviet imports of US equipment and technology. The relaxation of US export controls since

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detente contributed to the rise in imports, although controls continue to limit access to very specialized and sophisticated foreign technology.

5. The commitment to give the consumer a higher level of living is another major concern of the Soviet leadership; quality foods and a better assortment and quality of durables are the primary objectives.
6. The dwindling supply of cheap resources, particularly oil, also is high on the current economic agenda.

IV. How have the Soviets Responded to these Needs and Problems

- A. The leadership team that assumed power in 1964 has proceeded on a number of fronts in attacking their economic problems.
  1. The current regime unlike its predecessors, has given agriculture a consistently high priority.
    - a. Since 1965, the share of total investment going to agriculture has averaged almost 20%. American agriculture gets less than 5% of US investment.
    - b. Average incomes of farmers have risen by over one-half during the Brezhnev regime while nonfarm incomes increased by one-third.

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c. Brezhnev has just announced an enormous program to increase and upgrade the farm lands of European Russia.

(1) Last month, he declared that 35 billion rubles would be spent during 1976-80 in the first phase of a 15-year project to develop the non-black soil region of the Russian Republic. This amount is equivalent to almost one-fourth of the total agricultural investment planned for 1971-75. The plan calls for reclamation or improvement of 124 million acres -- 79 million of crop land and 45 million of grazing land. The crop land would be equivalent to about 15% of current sown acreage. Although the non-black soil area has large tracts of boggy, uneven land, it has high annual precipitation and responds well to the application of lime and mineral fertilizer. The Soviets hope that the non-black soil region will provide steady growth in grain production to counter erratic production in the new lands and the sometimes dry black soil zone.

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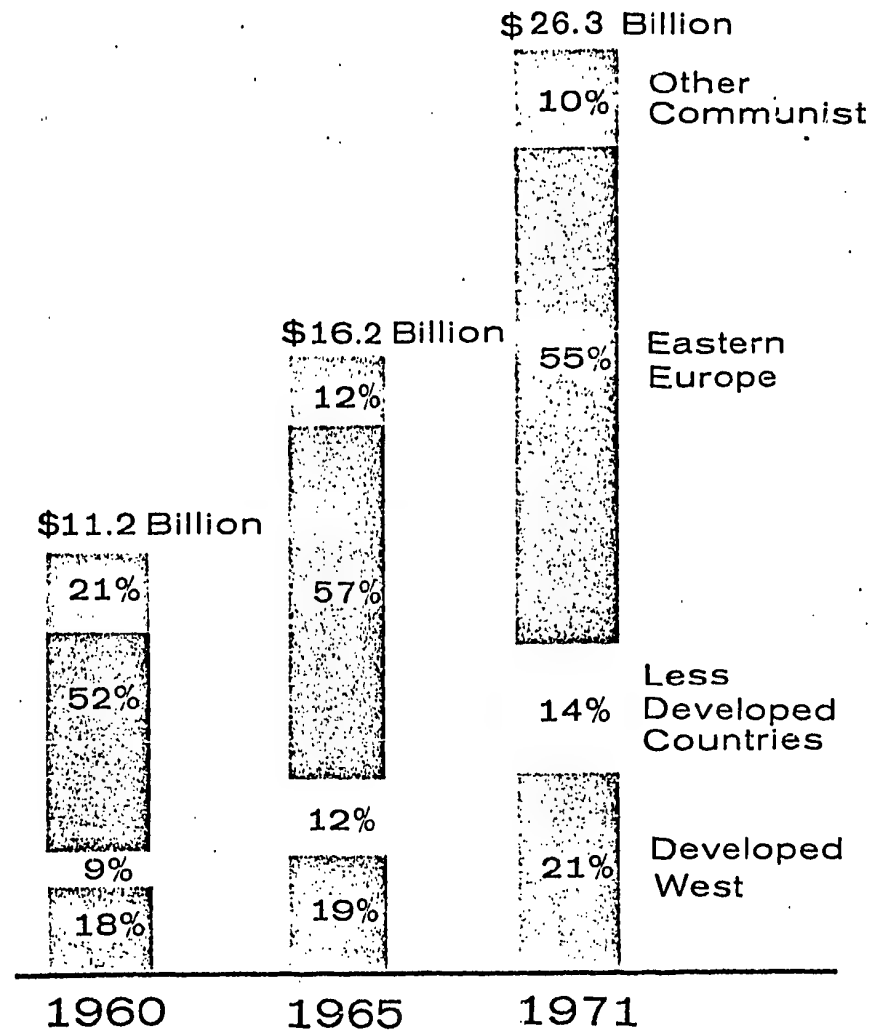
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- (2) The Soviets do not have a good track record in land reclamation, and the Brezhnev program is unlikely to work out as announced. In any case, major benefits from the new program will not appear before 1980.
2. Organizationally, the 1965 economic reform attempted to improve economic efficiency by making managers cost and profit conscious. It enjoyed very limited success because managers were still told to meet output goals at all costs. Continued tinkering with the system has not fundamentally altered managerial attitudes.
3. As interest in the economic reforms dwindled, Soviet attention to economic relations with the West increased.
- a. Traditionally, most of Soviet foreign trade has been conducted with Eastern Europe.
- b. But trade with the West has become especially important since the late 1960s.
- [Figure -- USSR Foreign Trade by Major Area]

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## USSR: Foreign Trade by Major Area (Exports plus Imports)



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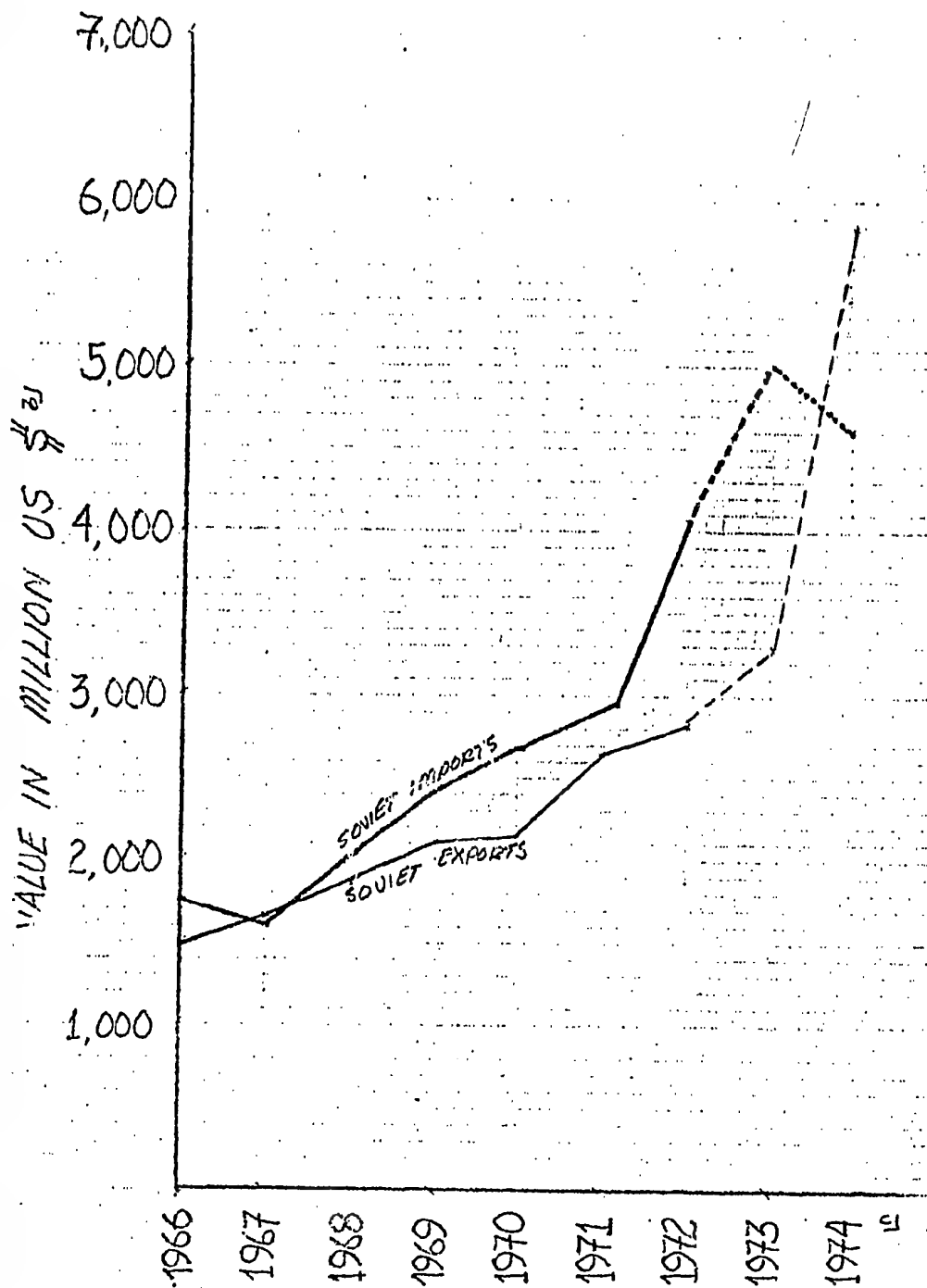
- c. Recently, the emphasis has shifted to trade with the US because only the US had the grains the Soviet Union desperately needed in 1971-72 and because the US relaxed the controls on sales of machinery to the USSR.
- d. Almost all Soviet trade with the developed West and some less developed countries is paid for with hard currency, as distinct from barter trade. An upsurge in imports from these areas has not been matched by increased Soviet exports, resulting in a hard currency deficit averaging about \$250 million annually during 1960-71. Until the mid-1960s, these deficits were financed primarily by gold sales. By the end of 1965, Soviet gold reserves were down to about 900 tons. After 1965 Western government-guaranteed medium- and long-term credits applied to Soviet purchases of capital goods replaced gold as the chief element in financing Soviet deficits.

Figure -- Hard Currency Merchandise Trade of the USSR

- (1) During 1966-71, the USSR sold very little gold, and reserves grew to an estimated 1,750 tons. Trade deficits were covered by an increase of Soviet

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*HARD CURRENCY MERCHANDISE TRADE OF THE USSR*  
1966 - 1974<sup>a)</sup>



a) 1973-1974 DATA ESTIMATED

b) VALUED IN CURRENT US \$

c) CRUDE OIL SOLD AT \$10 PER BARREL

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- medium- and long-term debt to the West to more than \$2 billion.
- (2) In 1971, debt service -- payments of principal and interest -- were equal to 17% of Soviet hard currency exports.
  - (3) The USSR's merchandise trade deficit with the hard currency area reached a record \$1.7 billion in 1973 --- largely because much of the grain purchased in 1972 was delivered in 1973. The USSR imported at least \$1.5 billion in agricultural products (chiefly grain) and about \$1.5 billion in machinery and equipment. Soviet export earnings were higher than in 1972, however -- in part because of higher prices for oil.
  - (4) To cover the 1972 deficit, the USSR relied on new government-backed net medium- and long-term credits and sold gold in substantial quantities for the first time since 1965.
  - (5) In 1973 the USSR took advantage of high gold prices and sold about 300 tons of gold for about \$950 million. Thus the burden of the USSR's recent trade

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deficits was lightened considerably by easy access to Western credits and by the windfall arising from the sharp increase in the price of gold. In addition, dollar devaluations permitted the substantial Soviet borrowing on the Eurodollar market in 1972 to be repaid with cheaper dollars.

VII. Turning Now to the Medium Range Prospects for the USSR

- A. The Soviet economy is likely to continue to grow at a rate considered good by Western standards, although somewhat slower than in the past.
  - 1. We estimate that the USSR can increase its GNP from 4½ to 5½ percent per year through the rest of this decade by adding new contingents of labor at about current rates while the pace of capital improvements slows slightly. Of course, this estimate assumes relatively stable internal and external political conditions.
- B. Expanded economic ties with the West will have an important place in Soviet plans.
  - 1. The USSR will almost certainly want to trade more with US, especially for high technology products.
  - 2. If trade relations with the US were broken, however, the USSR could find most of what it wants in Western Europe and Japan.

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- a. In this connection, the USSR and Japan initialed a document last month that could pave the way for one of the biggest economic deals between the two countries since the end of the Second World War. If a final agreement is reached, the Japanese will provide a credit of more than \$400 million to help finance a coal mining project in Yakutsk in eastern Siberia. In return, the Japanese will get more than five million tons of coking coal annually for 16 years beginning in 1983.
- b. The USSR has been particularly active in increasing its economic relations with West Germany. Recent discussions have centered on the possible West German construction of nuclear power plants in the USSR, and a contract was recently signed for the joint development of a \$1 billion iron ore and steel plant in Kursk, including approximately \$800 million in West German exports.

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- c. France has also continued to actively support Soviet development. Within the last year French firms signed a \$150 million contract for the development of a Siberian cellulose plant and a \$100 million contract for the design and equipping of five petrochemical plants. Discussions have also recently been held on French participation in the construction of a \$1 billion aluminum complex.
- 3. From the Soviet side, the possibilities for increased trade have improved. Soviet hard currency earnings, buoyed by rapid price increases for traditional Soviet exports and record gold prices, should rise rapidly over the next few years.
  - a. With expenditures for Western grain in 1974 expected to be half or less of 1973 outlays, these earnings could easily support a large

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rise of Soviet imports of Western plant, equipment and other goods. Imports of machinery and equipment, which rose sharply in 1972 and 1973, should increase even faster in 1974-1975. The volume of new contracts concluded in the past two years has already provided the basis for such an increase.

- b. Soviet exports should rise sharply during 1974-1975 because of the much higher prices the USSR will be receiving for oil and raw materials. With market prices expected to range between \$7 and \$10 per barrel, oil exports alone may earn the Soviets \$2-\$3 billion in 1974 and \$2.6-\$3.7 billion in 1975. Higher prices for wood products, chemicals, and coal, along with expanded deliveries of natural gas, could push total Soviet exports to almost \$6 billion in 1974 -- double the 1972 level -- and to almost \$7 billion in 1975.
- c. Soviet gold sales, however, represent the largest single additional source of potential foreign exchange earnings. Soviet gold reserves are currently estimated at about

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2,000 tons; more than adequate in view of the present level of long-term debt -- \$3.6 billion at the end of 1973. The Soviets would therefore be free to market most, if not all, of current gold production in Western markets. Gold sales of this magnitude could earn the USSR (at a price of \$150 a ounce) \$1 billion in 1974 and \$1.3 billion in 1975.

- d. By continuing to seek large Western credits, the USSR could buy even more over the short term. The leadership knows that continued borrowing at such levels will lead to a more rapid accumulation of debt and high debt service payments over the long run. Most of the large projects being negotiated in the West have called for medium- to long-term credits at interest rates less than the going market rate. But, in view of their improved export potential, Soviets may now pay cash for some of these purchases and forego the credits. They did just this last month when they agreed to pay cash for the West German equipment to be installed during the first stage of building the Kursk iron ore and steel plant.

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5. Over the long term, the Soviet leadership's most difficult problem in the economic sphere will be how to manage an increasingly complex economy.
  - a. The economic mechanisms devised by Stalin were effective in pulling the country up by the boot straps and establishing the basic foundations of an industrialized country.
  - b. The present system, however, pays too little attention to price, cost, and demand factors, and does not seem well suited to meeting the needs of a modern society.
  - c. The challenge facing the current leadership is to adjust the system to meet these needs without surrendering the power they hold so dear. No one -- either inside or outside of the USSR -- has advanced a convincing program for economic reform that would achieve this kind of balance.

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DCI CONGRESSIONAL BRIEFING

THE CHINESE ECONOMY

- I. Mr. Chairman, you asked that I also cover the Chinese economy, and single out the expenditures for military purposes. I propose first to discuss the general state of the economy, and conclude with the issue of military expenditures.

Overall Performance

- II. Since the Communists came to power in 1949, China's economic growth has been strong but erratic.

*(Graphic -- China's GNP)*

- A. China's GNP has grown by 4 percent annually reaching a level of roughly \$170 billion in 1973, less than 15 percent of US GNP. Per capita GNP of \$190 is only 3 percent of the US figure.
- B. National output, which rose sharply in the 1950s, plummeted in the early 1960s following the disastrous Leap Forward (1958-60). In 1966, just as momentum had been regained,

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Mao unleashed the Cultural Revolution, and production again declined. Since 1968, the economy has been growing steadily, and the latest ideological rumble--the anti-Confucius campaign--so far has had no noticeable effect on output.

C. Though still a poor country, the People's Republic of China can boast of many achievements, including:

--Provision of adequate if austere amounts of food and clothing for 900 million people.

--Production of modern military equipment including nuclear weapons, jet aircraft, and strategic missiles.

--Production of a wide and growing variety of industrial goods.

--Expansion of petroleum output from near total dependence on imports to a growing surplus for export.

--Extension of railroad lines through some of the world's most difficult terrain.

D. Nevertheless, China lags 5 to 20 years or more behind the other large industrial nations in various branches of technology. Although China

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has been outdistancing other less developed countries such as India, Pakistan, and Indonesia, it is not gaining ground on the fast-moving high-technology nations such as the United States and Japan.

*(Graphic -- China's GNP, Industry and Agriculture)*

- F. Until 1962, China's leaders stressed heavy industry and defense at the expense of agriculture and consumer welfare.
  - 1. Industrial production has grown by about 8 percent per annum compared to 2 percent for agriculture.
  - 2. After the "disaster years" of 1959-61--when China was brought to the verge of starvation--the regime shifted to an agriculture first policy.
    - a. The modern sector of the economy began to supply agriculture with increasing amounts of chemical fertilizer, pesticides, pumps, seeds, trucks, and farm machinery.

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- .b. Investment in industry reflected the new policy. Most notably, China in the past two years has contracted to buy more than \$1 billion worth of fertilizer and synthetic fiber plants to strengthen agriculture.
3. Concurrently, there appears to be some slowdown in military expenditures and increased emphasis on consumer goods.
4. Also, to give a fillip to industrial modernization, China has relaxed its policy of avoiding foreign debt by arranging to finance industrial plants through deferred payments.

Performance by Sector

III. When we look at Chinese economy sector by sector, it is apparent that agricultural production and its relation to population is still the basic problem. Some steps have been taken to ease the pressure on agricultural production.

*(Graphic -- Grain Production and Population, 1947-73)*

- A. China's population is about 900 million and is continuing to grow by about 2 percent per annum.

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B. Available arable land already is being cultivated, so major additions to output must be derived through increases in yields.

Large investments in fertilizers, water control facilities, and research are needed.

C. Though domestic fertilizer production--both from modern and local plants--has been rising rapidly, the regime has opted for a rapid boost in output by importing large fertilizer facilities from the United States, Western Europe, and Japan.

1. So far the Chinese have ordered 13 urea plants which will increase urea production 8-fold over present levels when they come on line in the late 1970s.

D. Large investments in synthetic fiber plants are aimed at relieving the pressure on agriculture to provide additional natural fibers at the expense of grain.

E. Considerable investment also has been made in water conservation, mostly in small projects in the south. In north China, major new investments will be required to provide large-scale irrigation systems.

*(Graphic -- Grain Imports, 1968-73)*

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F. In the meantime, China is spending large amounts of foreign exchange on grain and cotton. 7.5 million tons of grain, valued at \$750 million, were imported in 1973. Cotton imports also rose sharply to \$350 million in 1973.

IV. As for industry, China has vast resources of most raw materials, and industrial output is growing rapidly.

A. Energy resources are no problem. Coal and hydroelectric resources are huge, and petroleum deposits appear to be abundant.

1. Recent development policies have emphasized petroleum, while coal and electric power are falling short of needs.
2. Petroleum output exceeded 50 million tons (1 million b/d) in 1973, enough to meet domestic needs at the present level of industrialization and allow for exports of about 1 million tons to Japan. Production from land fields is being developed rapidly, but off-shore

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- exploitation will require further imports of expensive exploration and production equipment. Large investments in pipelines, railroad cars, port facilities, and tankers also will be needed to distribute the growing volume of petroleum.
3. Coal mining is being expanded with imported equipment, and electric power production is being strengthened by imported gas turbines, steam turbines, and boilers, as well as by expanding domestic production of generators and other electrical equipment. Steam power technology is far behind that of the West, and only a small portion of China's vast hydroelectric potential has been tapped.
- B. Though considerable progress has been made in metallurgy, particularly steel, China is still a net importer of metals.
1. Crude steel production, estimated at 25 million tons in 1973, was supplemented by imports of 3 million tons of high-quality finished steel. Both the raw material and finishing sectors are lagging. China

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is importing increasing quantities of iron ore, steel scrap, and pig iron, and has recently contracted for a \$400 million steel rolling plant from Japan and West Germany.

2. Imports of copper and aluminum are rising because China has failed to add new capacity as needed. China also imports lead, zinc, nickel, platinum, chromium, cobalt, and other metals while exporting tungsten, antimony, and tin.

C. China is one of the world's largest cotton textile producers. Nonetheless, production barely keeps pace with population growth. Cloth rationing is still an essential economic measure.

D. Despite striking gains in the production of machine tools and other types of machinery, many varieties and sizes are still lacking. Large quantities of advanced production equipment must still be imported to avoid reduced growth rates and large technological gaps.

V. In the field of transportation, the Chinese have proven adept at building railroads and highways in

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mountainous terrain. They have also developed a small transportation equipment industry that produces railroad equipment and trucks. Nevertheless, primitive forms of transport still handle most local traffic.

- A. Large quantities of transport equipment-- including trucks, ships, commercial aircraft, and diesel and electric locomotives--have to be imported.

*(Graphic -- Foreign Trade, 1957-72)*

VI. The patterns of foreign trade shifted radically following the withdrawal of Soviet technicians in 1960. As you can see on this chart, in 1959 the trade was at a ratio of 70 to 30 percent in favor of Communist countries. Since 1965, the figures have been reversed.

- A. Although foreign trade is only a small component of China's economy, it has been shooting up in recent years. Total trade jumped from \$4.3 billion in 1971 to \$8.5 billion in 1973. At least half of this increase probably is accounted for by revaluation of world currencies and worldwide inflation.

*(Graphic -- Composition of Foreign Trade, 1973)*



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- B. Major exports are textiles, foodstuffs, and raw materials. Imports, as I have already mentioned, feature grain, fertilizers, machinery, and metals.
- C. Trade with the United States jumped from \$110 million in 1972 to \$860 million in 1973. The US was second only to Japan in China's foreign trade.
  - 1. The US shipped nearly <sup>\$860</sup>\$860 million worth of goods to China, including wheat, corn, cotton, soybeans, aircraft, and metal scrap.
  - 2. In return, the US bought \$65 million worth of Chinese silk, pig bristles, fireworks, cotton fabrics, carpets, tin, and antiques.
- D. In 1973, China contracted for \$1.2 billion in whole plants--mainly chemical fertilizer and artificial fiber plants. Medium-term credits are being used to finance about two-thirds of these contracts.

Prospects - Mid and Long Range

- VII. When we look at the mid and long range prospects for the Chinese economy, we believe that GNP should

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continue to grow by 4 to 5 percent annually. Such a growth would be sufficient to support continued expansion of industrial capacity, to supply the population at slowly rising levels of well-being, and to improve the inventory of modern weapons available to the armed forces.

- A. The political campaign against Lin Piao and Confucius, however, should warn China watchers against facile straight-line projections of economic policy and growth prospects. Nevertheless, periods of political turbulence probably will have a smaller impact than in the past, because Communist economic organizations, controls, and priorities will be more resistant to change.
- B. The pressure of population against the means of subsistence should gradually be relieved by the growth of national output and, over the long term, by some successes in population control measures.
- C. Industrial output should increase about 8 percent annually, and agricultural output 2 to 3 percent.

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D. For the next 10 years or more, China will continue to benefit from its relative industrial backwardness by obtaining plant and equipment abroad on which R&D costs have been paid off and technical problems ironed out.

VIII. As for economic priorities in the future, agriculture should continue to receive extensive support from the industrial sector. In any case, steady increases in yields per hectare will be essential.

A. Rising pressure from an increasingly literate and technically sophisticated population will probably focus more attention on consumer welfare.

B. In industry, high technology will be emphasized, though small, local plants will account for large portions of output of consumer goods, construction materials, and farm machinery.

IX. In the field of foreign trade, China's oft-stated goal of self-sufficiency in industry and technology is not likely to be attained in the foreseeable future.

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- A. Peking must continue to rely heavily on Japan, Western Europe, and the US for various types of high-technology equipment.
- B. The United States will have a particular advantage in the supply of civil aircraft, advanced computers, communications equipment, oil exploration and drilling equipment, and specialized machine tools.
- C. The United States will remain a major supplier of agricultural commodities, especially grain in poor harvest years, and cotton.
- D. China, however, remembering its experience following the withdrawal of the Soviet technicians, will maintain a diversity of suppliers.
- E. Finally, Peking will try to bring its US trade closer to balance by modifying products to suit American tastes, and by expanding production of commodities with a ready market in the US. Nevertheless, Sino-US trade will continue to focus on US exports.

Expenditures for Military Programs

- X. I will conclude this prepared statement by discussing the Chinese commitment of resources to military programs.

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- A. At the outset, we should note that China has almost twice as many men under arms as does the US. More than 80 percent of this military personnel, however, is assigned to ground force units. The number involved with advanced weapons--such as strategic missiles, supersonic aircraft and modern submarines--is small by either US or Soviet standards.
- B. The Chinese are even more secretive about defense spending than the USSR: they publish no information on their military expenditures. We have recently begun an effort, however, to estimate China's resource commitment to defense, employing methodologies similar to those used in estimating Soviet defense costs. The results of this effort are still preliminary, but a few generalizations appear to be valid.
- C. The problem can best be approached by subdividing the question into two parts--defense operating costs and defense procurement costs.
  - 1. Defense operating costs would appear to have little impact on the economy, largely because of the extensive use of relatively unskilled manpower, which in China is certainly not a scarce resource.

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2. Military equipment procurement costs, however, impinge directly and heavily on the country's modest industrial base. The term "procurement" as we use it here includes only the cost of actually producing arms and equipment, and does not include any costs associated with research, development and testing programs. We have insufficient information to develop valid estimates of resources devoted to Chinese military research and development.

*(Graphic -- Trends in Chinese Military Procurement)*

XI. According to our measures, over the past ten years there has been a generally upward trend in Chinese military procurement, with two periods of rapid growth, each followed by a decline.

A. Of particular interest are the two occasions when the Chinese reduced procurement.

1. The first occurred in 1967 when the disruptions of the Cultural Revolution caused a 12 percent reduction.

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2. An even more drastic cut was made in 1972 when military procurement dropped by almost 20 percent, primarily as a result of a cutback in aircraft production. The reasons for this recent decline is not yet clear. Contributing factors may have been:

--New priorities in favor of economic growth established by a less military-oriented leadership in the wake of Lin Piao's purge in late 1971.

--An inability to develop follow-on advanced weapon systems.

B. As you can see on the chart, procurement in 1973 increased slightly over the 1972 level, but still remains considerably below the peak of 1971.

XII. Our measures do not yet give a good sense of the absolute level of outlays in Chinese cost terms. Still, some understanding of the defense burden on the economy can be gained by comparing the dollar index of military procurement with the index of growth in industrial production.

*(Graphic -- Military Procurement and Industrial Production)*

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- A. From 1964 to 1971 military procurement rose considerably faster than overall industrial output. Since 1971, the trend has reversed. This decline in the defense share may be illusory, however, because some procurement funds may have been diverted into military research and development.
- B. It should be borne in mind that military production preempts China's most modern production capacity and, more important, has first call on the nation's finest scientific, engineering, and managerial talent.

XIII. China's history of sudden bursts in defense production, and equally unexpected reductions, provides little basis for projecting future military procurement levels. Given the Chinese leaders' clear intention to develop modern, sophisticated weaponry, however, we expect the trend in procurement to be upward over the next few years.